No. 15447

United States
COURT OF APPEALS
for the Ninth Circuit

GRACE M. POWELL, Executrix of the Estate of O. E. POWELL, Deceased,

Appellant,

vs.

RALPH C. GRANQUIST, District Director of Internal Revenue,

Appellee.

REPLY BRIEF FOR THE APPELLANT

On Appeal from the Judgment of the United States District Court for the District of Oregon

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Re: Appellee's Distinction Between This Case and the First Trust and Savings Bank Case.

Throughout Appellee's brief, the assertion is made that the above quoted case, *First Trust and Savings Bank vs. United States,* 206 Fed. 2d 97, is distinguishable on its facts from this case. Appellant has cited this case for the controlling authority in support of her assertion that the decision of the lower court should be reversed. An analysis of the facts of that case would

indicate that the facts of that case are parallel to the facts of the present case. Drawing a parallel between the facts of that case and this case, one finds as follows: (Bearing in mind that some of these facts must be gleaned from the District Court opinion.) *Kraftmeyer vs. U. S.*, 52-1 USTC Par. 9328, decided May 13, 1952. Kraftmeyer's tax for the identical nine years in question, 1937 through 1945, inclusive, $76,738.18 (Dist. Ct. opinion); Powell's taxable income, 1937 through 1945, inclusive, $25,760.74. Both taxpayers pleaded guilty to a criminal charge under 26 U.S.C.A. Sec 145(a) for wilfully failing to make the income tax return required of him. Both failed to keep a formal set of books and records and the Internal Revenue Agent who investigated their cases was forced to look to subsidiary records to redetermine the taxable income. In neither case was there any evidence of the destruction of records, the alteration of any records or false entries made in any books. Both Mr. Kraftmeyer and Mr. Powell were successful in their business endeavors although Mr. Kraftmeyer made about three times as much net taxable income during the years in question as Mr. Powell. Some facts that make the Powell case much stronger than the Kraftmeyer case are that Kraftmeyer specifically made false statements to the examining agent. As the District Court observed:

> "Plaintiff was the only witness in his behalf. The Defendant produced two witnesses, one, Deputy Collector Ryan in Davenport, who first interviewed the Plaintiff in late 1946. He testified that when Plaintiff came in response to his call, he stated that he could not find his retained copies of income

> tax returns, that he had lacked time to search for them and that they were in his safe deposit box. The witness stated that twice during the interview Plaintiff had stated he made returns but did not have time to bring them with him. . . ."

The Court in the District Court further observed:

> "When first confronted he made false statements to the agent before admitting his dereliction. Plaintiff's entire course of conduct reveals what the Court must find in the light of the whole record to have been not only an omission but an *intentional evasion of his duty to make an annual return of income and pay tax thereon.* After seeing and hearing the witness the Court accepts as true the agent's statement of Plaintiff's misrepresentation that he had filed returns and rejects Plaintiff's denial of the truth of that statement. . . ."

On Page 17 of Appellee's brief argument is made that the failure to file income tax returns over a sustained period of time would be the equivalent of fraud. In the *First Trust and Savings Bank* case, supra, (District Court opinion) the taxpayer in that case failed to file returns for the identical period that Mr. Powell failed to file returns.

To fully appreciate the full significance of the *First Trust and Savings Bank* case, supra, one should read the opinion of the Court of Appeals for the Eighth Circuit together with the District Court opinion. When one does that, additional facts are adduced that make the case before this Court appear much more favorable than the *First Trust and Savings Bank* case, supra.

The Appellee made much of the fact that Mr. Powell seemed antagonistic toward the internal revenue agents

who investigated him. However, we are concerned with the acts that took place during the taxable years 1937 to 1945, inclusive, and not with the acts during the course of investigation subsequent to these years. Our inquiry must be directed to acts that transpired during those years. On page 11 of Appellee's brief, the Appellee quoted from the opinion of the District Court Par. R. 81:

> "There is no evidence in the record of alteration or concealment of bank statements, cancelled checks or real estate contracts by the taxpayer. Mr. Powell said he did not have records and there is no evidence of these having been destroyed or falsely made. However, there was no need for him to make false records or destroy records in contemplation of an investigation by the Internal Revenue Service, when at the time the taxpayer wasn't making or filing any income tax return. The same is true of concealment of assets and other 'badges of fraud' to which reference has been made. *The mere fact that these acts were not apparent at the time he was failing to make returns does not mean they didn't exist.*"

The italicized portion of the above quote clearly demonstrates that the Court bottomed its finding on inferences and not on "clear and convincing evidence." There is no question that the government must prove fraud by clear and convincing evidence, *Ohlinger vs. United States,* 219 Fed. 2d 310 (C.A. 9th), a thesis which the Appellee readily admits in his brief (p. 23). However, such inferences are incompatible with the testimony of the Appellee's own witnesses on cross-examination. Harold Parsons, Special Agent, Internal Revenue Service, testified (R. 112):

"Q. Mr. Parsons, did you ever find any evidence of Mr. Powell having destroyed records?

A. No.

Q. Did you find any evidence of false records?

A. No."

Appellee's witness, Daniel S. Forsberg, Internal Revenue Agent, testified (R. 122):

"Q. Now, in your report of your investigation did you find that Mr. Powell had destroyed any records?

A. He said he kept no records.

Q. What I was referring to was cancelled checks and normal subsidiary records that you find in the taxpayer's possession.

A. The cancelled checks, as I stated before, were all there, and the bank statements except for the first half of 1937, when the checks were missing.

Q. Did you find any evidence of any attempt on his part to alter any of these records?

A. There was no alteration of any of the bank statements or cancelled checks that I examined; no sir."

Mr. Forsberg further testified (R. 123):

"Q. Were there any alterations on these real estate contracts?

A. The contracts that were given to us, that we requested, seemed to be in good order.

Q. So in your investigation you found no destruction of records, and no alterations of subsidiary records and these real estate contracts which you stated.

A. The contracts were in order that we saw. The bank statements and cancelled checks except for the checks for 1937—the first half—were in order, there was no destruction of those and nothing where I could see that they had been tampered with in any way."

Mr. Milkes, witness for the Appellee, testified as follows (R. 156-157):

"Q. Mr. Milkes, in your work in accounting you are primarily looking for—one of your primary purposes is looking for discrepancies in records, is that correct?

A. Yes, I would say that is correct, not looking for fraud or anything like that but looking for errors in recording the information for accounting purposes—for tax purposes and I might say, incidentally, for fraud also.

Q. It is your nature to observe in going through data for accounting, any irregularities such as alterations?

A. Yes.

Q. And it is your practice to observe any destruction of records or subsidiary records?

A. Well, sure, if there is any evidence of it.

Q. Then, chances are, in the course of your examination, if there had been any alterations or destruction of these records it would have come to your attention?

A. Yes, sir.

Q. Were the subsidiary records that were made available to you for the taxable years 1937 to 1945 adequate to fairly reconstruct the income and expenditures of Mr. Ora E. Powell?

A. Substantially so, yes.

Mr. Jones: Your witness.

Mr. Andrews: No further questions.

Mr. Jones: I would like to call Mr. Lee Powell to the stand."

Re: Appellee's Argument on the Applicability of Section 293(b) Internal Revenue Code of 1939 (A 50% Civil Addition to Tax) Rather Than Section 291(a) Internal Revenue Code of 1939 (A 5% to 25% Civil Addition to Tax for Failure to File a Return).

On page 14 of the Appellee's brief, argument is made that in all cases the wilful failure to pay tax known to be owing requires the invoking of Section 293(b), (the 50% civil addition to tax) instead of Section 291(a), (the 5% to 25% civil addition to the tax) for failure to file a return. There is no question in this case that the lesser penalty has been assessed and collected and no contention is being made that the civil penalty should be returned to the taxpayer. The taxpayer's contention is that the 50% civil addition is inapplicable because no overt of commission has been proved by the Appellee by *clear and convincing evidence.* Appellee's argument is that the wilful failure to file a tax return results the lesser penalty, but the wilful failure to pay the tax in addition to the wilful failure to file a return the greater penalty as well as the lesser penalty attaches. The Appellee correctly argues that the civil penalties is a remedial section "provided primarily as a safeguard for the protection of revenue and to reimburse the heavy expense of investigation and loss resulting from the taxpayer's fraud." Citing *Helvering vs. Mitchell,* 303 U.S. 391, 401. The statutory language of Section 291(a) is as follows:

> "In case of any failure to make and file returns required by this chapter, within the time prescribed by law or prescribed by the commissioner in pur-

suance of law, unless it is shown that such failure is due to a reasonable cause and not due to wilful neglect there shall be added to the tax: 5% if failure is for not more than 30 days with an additional 5% for each additional 30 days or fraction thereof during which such failure continues, not exceeding 25% in the aggregate."

The plain implication of the language contained in this penalty provision is there would also be a non-payment of tax because before the penalty would produce revenue, there must be a tax due and owing.

Section 293(b) (50% addition to tax) specifically reads:

"Fraud.—If any part of the deficiency is due to fraud with intent to evade tax, then 50% of the total amount of the deficiency if in addition to such deficiency shall be assessed, collected and paid in lieu of the 50% addition to the tax provided in Section 3612(d) 2."

The Appellee is attempting to add the language "wilful failure to pay tax known to be owing" to the above quoted section. If Congress had intended that result they would have written that section in the same fashion they wrote such sections as Section 145(a), Internal Revenue Code of 1939, which provides specifically

" . . . any person required under this chapter *to pay* an estimated tax or tax . . ."

and

" . . . who wilfully fails *to pay such estimated tax or tax . . .*"

Section 294, Internal Revenue Code, is headed by the following caption:

"Additions to the tax in case of nonpayment."

Since no 50% penalty is contained in this section, it would seem that the statutory construction as contended by Appellant would follow. In case of doubt, taxing statutes are construed most strongly against the government and in favor of the citizen. *Gould vs. Gould,* 245 U.S. 151; *Semietanka vs. First Trust and Savings Bank,* 257 U.S. 602; *McFeely vs. Commissioner,* 296 U.S. 102.

In *New Colonial Ice Co. vs. Helvering,* 292 U.S. 435, the Supreme Court held that since every deduction from gross income is a matter of legislative grace, any particular deduction is allowable only if there is a clear provision therefor and hence a taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms. The reverse of this thesis should be true, particularly more so when a penalty is being enacted, i.e., if the government is to exact a penalty from the taxpayer it must show a positive provision for the penalty and show that it comes within its terms. Since the penalty that has been exacted here was for fraud, the government must go further and show by clear and convincing evidence that it comes within the statute.

The Appellee seems to be putting a strained construction on the word "fraud" as used in Section 293(b) of the Internal Revenue Code. As the Supreme Court has said in *DeGanay vs. Lederer,* 250 U.S. 276:

> " . . . statutory words are presumed to be used in their ordinary and usual sense, and with the meaning commonly attributable to them."

When "fraud" is used in its common ordinary sense it

contemplates affirmative action on the part of the taxpayer and not passive neglect. Throughout Appellee's brief he makes reference to the continued failure to file returns over a period of time as elevating this omission from the lesser penalty to the greater penalty, i.e., from Section 291(a) which specifically provides for the wilful failure to file tax returns to Section 293(b), the greater penalty fraud. It would seem to be a strange construction, indeed, to say that where the statute clearly defines an offense, failure to file returns, Section 291(a), that two of these clearly defined omissions would place it in another section of the Internal Revenue Code.

On page 23 of Appellee's brief the following statement is made:

> "A taxpayer with sufficient taxable income to require the filing of returns might have sufficient deductions, if he filed the return, to avoid payment of any tax whatsoever. If he wilfully omitted to file such a return he would be technically in violation of Section 291(a), or he could be convicted of a misdemeanor under Section 145(a), since the requirements of that penalty statute are similarly satisfied, but where a taxpayer wilfully omits to file a return and the omission results in substantial taxable income never being brought to the attention of the taxing authorities, as a consideration separate and apart from the Section 291(a) violation, the omission or concealment produces the direct result that tax has been evaded, with the wilful purpose to omit the filing of the return serving to warrant the inference of evasion."

This statement of the Appellee would make Section 291(a) meaningless in our taxing framework. It must be pointed out that Section 291(a) is placed in the In-

ternal Revenue Code as a producer of revenue for the purpose of compensating the government, which argument has been made in Appellee's brief and agreed as being a correct interpretation of the law by Appellant in this reply brief. But yet, Appellee would argue that if the taxpayer failed to file a return and no tax is owing, he would be in violation of Section 291(a). This interpretation would make Section 291(a) meaningless, as to collect a penalty there must be a tax due and owing upon which to attach the penalty. As his example states, the taxpayer would have sufficient deductions to avoid any payment of tax. There would be no revenue produced as the penalty attaches to the tax due and owing. In any event there would be no tax due or owing, whether he filed a return or whether he failed to file a return, and the invocation of Section 291(a) would not produce a penny's worth of revenue for the government to compensate them for their efforts in detecting the omission.

The case of *Schwarzkopt vs. Commissioner,* decided July 10, 1957 (57-2 U.S.T.C., Par. 9816) is clearly distinguishable from the case at bar because there the taxpayer filed tax returns and failed to report substantial amounts of income over a number of years.

Conclusion

The Appellee summarizes his argument, Appellee's brief, pages 25 through 34.

1. Taxpayer was aware of his duty to file income tax returns and yet he failed to file.

2. Appellee argues that taxpayer was aware, throughout the period under review, that he had taxable income which he was not reporting. He bottoms this fact on the fact that Carl T. Armstrong, the government's witness, so advised him at the beginning of the period in question. (It is impossible for any business man to forecast whether he will have taxable income in a taxable year at the beginning of the fiscal period.)

3. The awareness on the part of the taxpayer of his responsibility to file federal returns and his failure to file was wilful.

4. The taxpayer did not keep books and records. All of these acts as alleged by Appellee in his brief are merely acts of "wilful neglect" the exact penalty prescribed by Section 291(a) 25% penalty which is not being controverted here and which has been collected by the Appellee.

For the reasons stated above the decision of the District Court for the District of Oregon should be reversed and judgment entered for the Petitioner allowing a refund of $12,880.39 plus interest fram the date of payment.

Respectfully submitted,

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